U.S. FINANCIAL TURMOIL AND IMPACT ON KOREA'S ECONOMY

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Black September, Meltdown Monday, America's Financial 9/11, Financial Tsunami, Perfect Storm, worse financial crisis since the Great Depression 1929… Whatever the term used, recent events on Wall Street will certainly go down in the record books. The speed at which so many prestigious financial institutions collapsed is a dramatic turning point in U.S. financial history. Former Federal Reserve Chairman Alan Greenspan described it as a "once-in-a-century" financial catastrophe. When historians write about the current crisis, much of the blame will go on the failure of the housing and mortgage market. Is Korea safe from U.S. financial turmoil? The short-term impact may be limited, but a global economic slowdown would have a greater impact on the nation's growth in the long term.

Failures and Rescues of Major Financial Institutions

Lehman Brothers, a 154 year old financial powerhouse which survived the American Civil War, two World Wars, and the Great Depression, filed for bankruptcy on September 15. It was the largest corporate bankruptcy in the history of the world. But the failure of Lehman Brothers was just one of a series of astonishing developments that sent shockwaves through financial markets around the world.

On that weekend, Merrill Lynch, another ailing investment firm, was acquired by Bank of America. The third largest investment bank was valued at $100 billion last year, but was sold for just $50 billion. Two days later, the Federal Reserve extended an $85 billion loan to American International Group (AIG), one of the world's biggest insurers, in exchange for warrants entitling it to an 80% equity stake in the company, if the loan is not repaid. At its peak, AIG was the world's largest financial company with a market value of $239 billion. The government's rescue of a desperately illiquid AIG was the biggest bailout in American history. Then, more dramatic news came with the bailout of the commercial bank Washington Mutual Inc (WaMu). In what is by far the largest failure in U.S. commercial banking history, federal regulators seized the severely troubled WaMu and sold parts of its operation to JPMorgan Chase & Co. in an emergency deal. Because of its heavy exposure to the mortgage crisis, WaMu's shares had plunged 85% this year.

All of these events occurred in the immediate aftermath of the $5.2 trillion effective nationalization of home mortgage giants Fannie Mae and Freddie Mac on September 7. Reckless lending and bad decisions caused these two companies, responsible for about half of America's $12 trillion mortgage market, to collapse. This move came only six months after the federal government provided $30 billion to help JPMorgan Chase & Co. to take over another investment giant, Bear Sterns.

In response, the White House and Congressional leaders proposed a $700 billion rescue package, the biggest banking bailout in U.S. history. Under this program, the government would buy distressed mortgage-related assets and resell them later when the markets regained confidence, providing immediate liquidity to the tight credit market so that banks can start resume lending. This proposal came after the federal government had already promised more than $600 billion in the past year to bail out, or help bail out, some of the biggest financial companies.

What Happened and What Next?

What caused the market to collapse? It started when banks provided mortgage loans to people with less than adequate credit history, without adequate attention to the process of credit checks and repayment risks. These banks packaged these loans as marketable securities and sold them to investment banks, such as Lehman Brothers and Merrill Lynch. With such large amounts of money boosting the real estate industry, housing prices started to skyrocket. When the real estate bubble burst, housing prices fell. Many marginal borrowers defaulted, as they could not keep up with monthly payments and had negative equity in their homes. Investment banks that had invested heavily in collateralized securities suffered substantial losses.

Some analysts said that a financial crisis caused by a housing price crash usually lasts two to three years and that a recession is likely over the next 12–18 months. As the events of the last few weeks in U.S. markets continue to unfold, financial markets around the world will undergo disruptions, uncertainties, and speculation, as it is very difficult to determine the value of the discredited securitized subprime mortgage loans.

What is the Damage for Korea?

Korean financial institutions learned lessons from the 1997 financial crisis, which was partly caused by weak risk management. Comparable to the U.S. financial turmoil prompted by the subprime mortgage crisis, Korean banks had recklessly loaned money to large companies for questionable projects and property investments, and they chased high-yield, high-risk investment around the world. As a result, Korea closed 14 merchant banks, and some other banks were either sold or merged.

This is not to say that Korea has not been affected by the U.S. financial crisis. Korean financial authorities were closely watching the situation and determining how much the nation's financial companies had invested in failed U.S. financial institutions. According to the Financial Supervisory Commission, Korean financial institutions had invested a total of $2.72 billion in Merrill Lynch, which was acquired by Bank of America. Korea Investment Corporation (KIC) bought $2 billion worth of Merrill Lynch's preferred stock in January, but some of these stocks were converted into cash worth $88.5 million at the end of July, and the remaining preferred stock was converted to common stock at $27.5 per share. KIC is the third largest shareholder in Merrill Lynch, following Singapore's state owned investment company Temasek and the Kuwait Investment Authority. Hana Bank had $50 million dollars equity in Merrill Lynch, bought at $24 per share. In both cases, the average price paid was reportedly lower than Bank of America's offer of $29 per share, indicating that the damage would be limited.

However, it seems that losses are inevitable for other Korean financial institutions, which have invested a combined total of $720 million in Lehman Brothers. According to the Financial Supervisory Commission, brokerage houses invested $390 million worth of Lehman's derivatives products, while insurance companies and banks have extended loans to asset- and mortgage-backed securities worth $210 million and $120 million, respectively. Although it depends on how each company managed the risks involving products issued by Lehman, it is highly likely that these financial institutions will have to absorb a considerable loss

The National Pension System also lost heavily. It had invested 17% of its total 228 trillion won assets in domestic and foreign stocks, and 80% in local and foreign bonds. It suffered a 66% loss on the total of $72.2 million invested in Lehman Brothers, Merrill Lynch, and AIG. It bought $42 million worth of AIG bonds and stocks but saw 84% of AIG's equity disappear when the insurance giant was bailed out by the U.S. government.

Long-Term Ripple Effect on Korean Economy

Although Korea's direct exposure to failed U.S. financial institutions is limited, Korean economy and financial markets will experience turmoil in the months to come. Korea's economy was already stagnating. The International Monetary Fund downgraded its forecast of Korea's economic growth for 2008 to 4.1% from the 4.2% it predicted five months ago. The OECD also lowered its growth prediction—to 4.3% from 5.2% in June. Although it is difficult to forecast next year's growth rate with so many variables to consider, most analysts agreed that it is unlikely that the economy will rebound next year with the global economic slowdown.

Because of the current financial crisis in the United States, growth of Korea's exports will be greatly reduced. The nation's robust export growth has been reflected in an increase in shipments not only to the United States but also to emerging markets. But the current turmoil will slow the growth of these countries, and thus result in slower growth of exports to them. Furthermore, if the situation in the United States continues to falter, stock prices will drop, and businesses and households will have difficulty borrowing from banks, leading to further declines in business activities and private consumption.

The U.S.-sparked financial crisis is also hurting Korea's small and medium-size businesses. Local banks have already tightened their credit-risk management procedures, making it difficult for these companies to borrow money. This could hurt production and investment in the real economy. Also, local banks will face difficulties in borrowing money from overseas due to worsening conditions in global markets, creating cash shortages for local banks and companies. Moreover, there could be a selling panic on the Korean stock market as foreign investors try to liquidate their holdings. The Korean government cautioned domestic investors to avoid overreacting, as panic selling could create a serious market instability.

The world has seen what happened to Wall Street. It is inevitable that the situation will become worse before getting better. Is Korea ready to embrace the global financial crisis?